RESIDENTIAL MARKET UPDATE.

Knight Frank

FEBRUARY 2011
SPRING MARKET OUTLOOK.

"The all-important spring house-selling season will soon be underway. The mainstream market is showing signs that we ought to expect a weaker start to the year compared to 2010. The prime markets in London and the regions are holding up, although even here supply is rising and demand is beginning to weaken slightly. While the UK's economic prospects are critical to the performance of the market, the real determining issue is the ability of borrowers to access mortgage market funding, and there may be some better news on this point."

Liam Bailey, Head of Residential Research, Knight Frank

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The situation now

Ongoing weakness in the wider UK housing market has contributed to house prices turning negative on an annual basis (down 1.1% in the year to January), for the first time since August 2009.

As we reported last month, while we appear to have left behind the much stronger housing market conditions seen a year ago, in retrospect the strength of the market at this time was misleading. Prices rose in late 2009 and early 2010 in reaction to very low financing costs and also very low levels of stock availability which, despite a weaker than normal level of demand, translated into higher prices.

Looking at our present situation, supply is still relatively low, with available stock down 20% compared to January 2009, but higher by 22% compared to January 2010. The number of buyers in the market peaked last summer and has been in decline since - headline volumes of new buyers in January were 10% lower than a year ago.

The most worrying measure for the market is the ongoing dearth of mortgage lending. Mortgage approvals for house purchases had been rising steadily from their low point of 27,000 in November 2008 to hit 59,000 in November 2009. Since this point mortgage lending has fallen backwards, hitting 42,563 in December 2010, a 10% drop from the previous month and the lowest number of approvals since early 2009.

While the headlines from the mortgage market are still overwhelmingly negative there are a few chinks of light. The Council of Mortgage Lenders confirmed in January that a revival in the UK residential mortgage-backed securities (RMBS) and covered bonds markets may have begun. Both markets have been effectively closed since late 2007, yet prior to the crash they generated funds sufficient to finance more than 70% of net lending in 2006.

A functioning RMBS market would be unlikely to herald a rapid expansion in new lending - banks will look to pay down government debt under the Special Liquidity Scheme first - however it will be a key part of the market revival.

Last month we outlined the three key issues that we believe will dictate the outlook for the UK housing market, namely: falling household incomes, mortgage market restrictions and the risk of rising interest rates.

Even more important than these issues are the UK's economic prospects. The negative

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Q4 2010 GDP figure might be explained by the impact of the pre-Christmas snow. However it does not disguise the fact that, with the exception of the manufacturing sector which is benefiting from the emerging world's growing demand for imports, the wider economy is struggling to maintain growth.

At a household level, the impact of rising taxes and stubbornly high inflation are not being offset by wage rises. An increasing number of employees are actually facing pay freezes or below inflation rises.

Despite the hope offered from RMBS activity, we expect to see the mortgage lenders continue to target the affluent by maintaining the very wide differential in lending rates between the low rates offered to those with deposits of 25% or more and the much higher costs passed on to those with limited equity.

If strong inflation continues into 2011 the Bank of England will be forced to raise interest rates before the mortgage lenders are able to narrow margins. This will not only hamper the sales market, but also cause problems for existing owners, many of whom have been benefiting from very low variable rate mortgages.

Prime market performance

In central London, tight supply of stock and resilient demand pushed prices higher by 1.1% in January 2011. Recent price performance has contributed to annual price growth of 10.3% in the 12 months to January.

Prices are now 26.9% higher than in March 2009 and 3.4% lower than their all-time peak reached in March 2008.

London has bucked the wider UK trend in recent months, with strong price growth and resilient demand for property. Whereas prices in the wider UK market fell by over 1% in the year to January, central London saw continued double digit growth.

Demand for property has been strong - applicant volumes were 13% higher in the three months to January compared to the same period a year earlier. The real drivers of this demand have been overseas buyers, especially Europeans, and also City-based buyers, who have been more numerous than expected given the uncertainty over bonus levels.

A marker of the strength of the London market is shown by the fact that viewing volumes were up by 30% year-on-year in January.

On the supply side, the ongoing issue of limited stock continues. While stock volumes are running at 3% above the level seen a year ago, they are still down by over 20% compared to January 2009.

Current rates of sale compared to stock volumes are still running at approximately 10%, far above the long-run average of 7% to 8% - again confirming the limited availability of stock for buyers to choose from.

Central London residential rents rose 2.2% in the final quarter of 2010. This rise means that rents have risen by 16% over 2010 as a whole and by 19% since their low point in mid-2009 when the market was suffering from significant over-supply.

Rents are, however, now 5% below the peak level they hit in March 2008 before the impact of the credit crunch was fully reflected in the market.

The volume of available rental properties throughout the year was 20% lower than in 2009, and - even more strikingly - down by 36% compared to 2008. Set against this reduced supply was the fact that the volume of prospective tenants fell only marginally (by 1%), compared to 2009, but actually rose by 10% compared to 2008.

Why has the rental market seen such demand from tenants? Two reasons stand out. Firstly, employment conditions in central London are much healthier than they were in 2009. Morgan McKinley, the City recruiter, noted that the number of new positions advertised in the central London financial and business services sector rose by 9% in November 2010 compared to November 2009.

Secondly, in addition to the strength of London's employment market – the fact that the sales market is still struggling to create stable growth in the number of deals means that many prospective buyers are still locked out of owner-occupation and have to consider rental as an alternative. While central London sales are outperforming the UK market, even here sales volumes in 2010 were 36% lower than in 2007.

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Development land and new-home prospects

The rate of growth in English residential development values slowed rapidly in the final quarter of 2010. While greenfield land still managed a rise of 2% between October and December, English urban land values fell by 1% and in Greater London the fall was more significant at -2.5%.

The only urban market to avoid price falls was the prime London market, which registered no change over the quarter.

The recent slowing in quarterly growth has pulled back annual rates of growth, which had hit 26% in prime London in Q2 2010. Greater London annual price growth ended the year at 4%, down from the 14% hit during the summer.

Despite rising values during 2009 and 2010, average residential development values in December 2010 were still 40% below their Q4 2007 peak.

The residential land market has been a fairly bright spot in the property sector over the past two years. While transaction volumes were well down on peak levels – there has been a steady recovery in pricing – on average values have climbed by around 20% from their early 2009 low.

As we move into 2011, problems are emerging, which seem likely to pull back some of this recovery in values.

Funding problems continue to provide major difficulties for developers. In most cases there is no funding available for sites without planning consent, and even for land with a consent, loan to values of 50% and possibly 60% are the maximum provided.

The few cash buyers in the market, who drove values forward in late 2009 and early 2010, have already spent a significant amount of money on sites over the past 24 months and are running low on funds.

There is a risk for 2011 that with an increasing level of stock coming into the market, due to bank restructuring, that supply will begin to rise just as demand is falling back.

Our view is that land values are likely to fall back in 2011, but land transactions are likely to rise as supply from receivers begins to edge higher.

That said, there are some positive market trends, which should support pricing in the more desirable areas of the country – especially greenfield, southern England markets.

The main support for the land market is the ongoing scarcity of new-build properties, with 2010 new-build completions estimated to be c.101,000 (for England), still 42% below the total reached in 2007.

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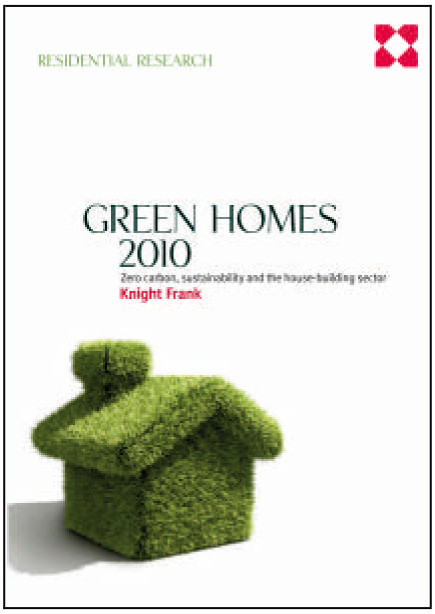

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